

2.07 Long-Term Contracts

Overview

Many industries provide services that may require several accounting periods to complete. The construction industry is one example. Contractors may enter contracts with governmental units to construct infrastructure, including roads and highways, which may require several accounting periods. These circumstances call for the use of **long-term construction-type contracts** that, in some cases, will have a single distinct performance obligation.

In other industries, companies will enter long-term supply contracts because their customers want to be able to rely on a supply of a resource that is considered critical without the need to renegotiate every purchase. Thus, suppliers will use **long-term production-type contracts**, which may:

- Commit the customer to purchase all output produced by the supplier, usually with limitations
- Commit the supplier to produce all of the resources needed by the customer
- Commit the supplier to produce and the customer to purchase a certain amount or quantity of the resource over an extended period of time

Recognizing revenue over the course of these contracts makes sense because the work that generates the revenue is performed over the term of the contract. ASC 606 indicates that certain conditions must be met for the entity to recognize revenue while the performance obligation is being satisfied. Otherwise, revenues are recognized upon satisfaction of the performance obligation.

Long-term construction contracts often allow the contractor to bill the customer at intervals, as it reaches various milestones in the project. These billings do not represent the amounts that should be recognized as revenue and are generally for amounts that are lower than what a payment would be for a proportionate amount of work completed on the contract. They are generally designed to:

- Make certain that the customer has enough of an investment in the project to assure the contractor that the customer will meet its obligation to accept and pay the contractor
- Provide the contractor with working capital to enable the contractor to pay sub-contractors and for materials, providing assurance to the customer that the project can be completed
- Make certain that the contractor has something to gain (ie, the remaining unpaid balance on the contract) by completing the contract on a timely basis

Costs of Obtaining & Fulfilling a Contract

Costs incurred in satisfying a performance obligation will be accumulated and reported on the income statement (I/S) in the period in which the related revenues are recognized.

- When recognizing revenues while the performance obligation is being satisfied (aka, the percentage-of-completion method*), costs are charged against income in proportion to the revenues being recognized.

- When revenues are recognized upon satisfaction of the performance obligation (aka, the completed-contract method*), costs are recognized upon the completion of the contract in the same period in which revenues are recognized.

*Note that the revenue recognition standards and the CPA exam no longer use the specific terms "percentage-of-completion method" and "completed-contract method," but the accounting under the new standards is so similar that this terminology is still used in practice.

Costs incurred are inventoried as they occur in a *construction-in-progress (CIP) account*, while billings are accumulated in a current liability account called *billings on uncompleted contracts*. Notice that both accounts are current, not long-term. This is because the income from such contracts is realized in only *one operating cycle* of the company; when the cycle is longer than a year, items that normally would seem to be long term are classified as current.

Some costs of obtaining and fulfilling a contract are expensed in the period in which they are incurred (eg, general and administrative costs). Other costs, however, should be **capitalized** in accordance with the principles found in ASC 340, *Other Assets and Deferred Costs*:

- **Recoverable incremental costs of obtaining the contract** – If the entity expects to recover the costs of obtaining a contract, they should be capitalized. These are costs that either:
 - Wouldn't have been incurred if the contract had not been obtained (eg, commissions), or
 - Are chargeable to the customer even if the contract is not obtained.

For example, a land broker has land zoned for agricultural use and a customer is seeking land zoned for multi-family residential units. Costs incurred to re-zone the property for the customer would be recoverable because the zoning change will increase the value, and the selling price, of the property.

- **Costs to fulfill a contract required to be capitalized by other standards** – Various ASC topics specify that some costs must be capitalized (eg, inventory) while others must be expensed.
- **Costs to fulfill a contract that meet all of the following criteria:**
 - The costs relate directly to a contract that is in existence or a specific contract that is being negotiated.
 - The costs generate or enhance resources that will be used to satisfy performance obligations in the future.
 - The costs are expected to be recovered.

The last category of costs includes those that are normally incurred and accumulated in construction in progress (CIP). Recovery of costs may be through collections of revenues on the contract:

- If they were anticipated when the contracts were negotiated, or
- They might have resulted from changes made to the performance obligation that are reimbursable by the customer.

Percentage of Completion versus Completed Contract Method

	Percentage-of-Completion Method	Completed Contract Method
Revenue recognition	<i>Over time</i> – as construction is completed	<i>At a point in time</i> – when construction is complete
	Appropriate portion of total revenue expected from the contract is recorded at end of each period (I/S)	No profit/revenue entries are made until completion (I/S)
	Billings and collections are recorded in B/S accounts	
Costs incurred	Charged against income in proportion to revenues recognized during period	Held in CIP account (B/S) until completion
	Anticipated losses recognized immediately (I/S)	
Conditions for use*	<ol style="list-style-type: none"> 1. Customer consumes benefits of asset(s) as they are delivered 2. Customer has <i>control</i> over asset(s) during creation or enhancement 3. Entity lacks alternative use for asset(s) and is entitled to payment for completion to date 	Customer has <i>control</i> over asset(s)
Measuring progress*	<i>Output method</i> – % complete with respect to output (eg, milestones reached, units completed, etc.) <i>Input method</i> – % complete with respect to effort put in (eg, costs incurred, labor hours, etc.)	

*Previously discussed.

Percentage of Completion: Cost-to-Cost Approach

The cost-to-cost approach is an *input method*. Under this method, the costs incurred to date are compared to the total estimated costs of completing the performance obligations; the resulting ratio is considered the percentage complete.

The profit recognized in each period is determined on the accrual basis, taking into account:

- The estimated profit on the contract,
- The portion of the contract that is completed (% complete), and
- Any profit that has been previously recognized.

Accounting During Year

- Billings are added to *billings on uncompleted contracts* (ie, a contra account to CIP).
- As cash is collected, the receivable is reduced.
- As costs that qualify for capitalization are incurred, they are added to CIP.

All the accounting for percentage of completion and the completed contract method is the same up to this point.

- **Gross profit** is added to CIP. Gross profit for the current period is calculated as follows:
 1. Total contract price – Total construction costs = Total estimated profit
 2. Costs incurred to date / Total construction costs = % complete
 3. Total estimated profit × % complete = Gross profit (GP) to date
 4. GP to date – GP to date at end of last period = GP in current period
- At year end, **Billings and CIP are netted** on the B/S to report either:
 - *Current contract asset*: CIP in excess of billings
 - *Current contract liability*: Billings in excess of CIP
- The I/S will report:
 - **Revenue** earned to date = (Total contract price × % complete) – Revenue previously recognized
 - **Cost of sales** equal to costs (not profit) added to CIP during the current period

Roger Builders has agreed to construct a building for CPA Inc. at a total contract price of \$4,000,000. The estimated construction costs at inception are \$3,000,000 and the actual costs for both years 1 and 2 are below. The construction was completed after year 2.

Total contract price	\$4,000,000
<u>– Estimated costs</u>	<u>3,000,000</u>
= Estimated Profit	\$1,000,000

	Cumulative	
	Year 1	Year 2
Costs incurred to date	700,000	1,650,000
Estimated costs to complete	2,800,000	1,650,000
Billings	850,000	1,800,000
Cash collections	800,000	1,500,000

		Year 1		Year 2	
% complete	<u>Costs incurred to date</u> Total construction costs (ie, Actual + Estimated to complete)	<u>700</u> 700 + 2,800	20%	<u>1,650</u> 1,650 + 1,650	50%
x Total Profit *	Total contract price -Total construction costs	4,000 <u>-3,500</u>	<u>500</u>	4,000 <u>-3,300</u>	<u>700</u>
= Profit recognized to date			100		350
- Profit previously recognized			—(0)		(100)
= Profit to recognize this year			<u>100</u>		<u>250</u>

*Total Profit will always change, so use new profit amount.

	Percentage-of-Completion Method				Completed Contract Method			
Billings	Construction receivable	850			Construction receivable	X		
	Billings*		850		Billings			X
Collections	Cash	800			Cash	X		
	Construction receivable		800		Construction receivable			X
Costs	CIP*	700			CIP	X		
	Cash		700		Cash			X
Recognize Profit Year 1	CIP*	100			No income until done			
	Gross profit on CIP (1/5)		100					
	CIP	100						
	Construction expense (3,500 × 20%)	700						
	Construction revenue (4,000 × 20%)		800					
*Net Billings (850) and CIP (800) on B/S at end of year = \$50 contract liability (ie, Billings in excess of CIP)								
Recognize Profit Year 2	CIP	250			No income until done			
	Construction expense [(3,300 × 50%) – 700]	950						
	Construction revenue [(4,000 × 50%) – 800]		1,200					